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H FOR CODEL LUGAR

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SUBJECT: SCENESETTER FOR LUGAR CODEL MEETINGS WITH EU
OFFICIALS ON 3-4 SEPTEMBER, 2008

¶1. (SBU) Welcome to Brussels. Your visit comes as the EU struggles to develop a common energy policy, internally and externally. One goal of the French EU Presidency is to reach political agreement by the end of the year on the EU Commission proposals on internal energy market liberalization and climate change. This will not be easy as the proposals face opposition from member states intent on protecting their large energy firms and their prerogatives over the energy mix. The debate turns on "unbundling" at natural gas and electricity energy conglomerates. That is, separating as enterprises the supply (power generation or gas supply) from the transmission, as we have been doing in the U.S. for some years now. Mixed into this question is whether Russia's Gazprom should be able to buy up European companies in the gas and electricity sectors. Gazprom as the ultimate supplier of 25 percent of the natural gas used in Europe (with almost total dominance of the market in Central Europe) could put itself in complete control of the vertical energy chain in Europe. Starting with the gas wellheads in Siberia and ending at the meters attached outside apartments in Poland, Germany, and France. The Europeans should quake at this prospect and are. A deep uneasiness about Europe's dependence on Russia as an energy supplier adds to this ferment. The Commission and the Council are working together to develop a more coherent external energy strategy for the EU. Finally, Climate change issues are embedded in the EU psyche and play a part in any European discussion of energy issues.

¶2. (SBU) The Europeans view energy security in broad terms -- to include alternative sources and supply of gas, development of additional renewable resources, research into clean coal, and the construction of nuclear power plants in EU member states that favor nuclear power. And overlaying the energy security debate here is the imperative that European leaders see to combat climate change. It is thus almost impossible to have energy-related discussions here in Brussels without addressing each of these parts of energy security: internal EU market liberalization, measures to address climate change, and external energy policy. You can, and we hope will, use this connection to our advantage, by underlining our common need to collaborate in the development of new energy technologies to address our climate and energy security concerns.

¶3. (SBU) Your schedule here covers:

-- Energy Commissioner Piebalgs. He has the lead role in the Commission on both the internal energy market liberalization and the energy/climate package; his is also the key Commission voice on external energy policy.

-- Common Foreign and Security Policy High Representative Solana. He works with the Commission on the EU's external energy policy, and can speak to the dynamics among the member states on this issue.

-- Competition Commissioner Kroes. She also plays a critical role on energy policy, as competition policy along with trade policy are two areas in which the Commission has autonomous power. Kroes has successfully used this power to go after major energy firms, notably in Germany and France, and U.S. companies such as Microsoft and Intel. But she has been reluctant to consider using the same powers to tackle anti-competitive practices by Russia's Gazprom.

-- EU Political and Security Committee. We have also arranged for you to meet informally with the Council's EU Political and Security Committee. This body has recently been concentrating on issues like combating piracy and the crisis in Georgia that have implications for the security of energy supplies. The PSC Ambassadors will also be doing preparatory work ahead of the September 5-6 informal meeting of EU Foreign Ministers in Avignon (the "Gymnich") in which Ministers are expected to discuss the situation in Georgia and informally brainstorm on transatlantic relations.

-- Tri-Mission Dinner. Ambassadors Silverberg, Fox, and Volker will be co-hosting a dinner for you with individuals involved in EU, Belgian, and NATO security policy.

-- Caspian Region Ambassadors. If time permits, you will also be meeting with the Ambassadors from Azerbaijan, Kazakhstan, and Turkmenistan. Each of these countries plays a role in the EU's plans to increase Europe's energy security

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by opening up a southern corridor to bring gas supplies from the Caspian region to European markets.

-- Director General for DG Agriculture, Jean-Luc Demarty. Also if time permits, we plan to arrange a meeting for you with the Director General for DG Agriculture, Jean-Luc Demarty, to discuss the inter-related issues of biofuels and genetic engineering. Mr. Demarty has been involved in the WTO Doha discussions on agriculture.

Proposals

14. (U) The energy sector has been something of an anomaly in the European Community, as the member states jealously guard their prerogatives over national monopoly utility providers and the energy mix. Russia's January 2006 cutoff of Russian gas exports to Ukraine was a wake up call for Europe on its vulnerability to a dominant Russian supplier. Russia's current conflict with Georgia will no doubt further these concerns.

15. (U) European Commission President Barroso and EU Council High Representative Solana saw their opportunity to bring energy more fully into the Community's ambit. As a result of their efforts, the EU is now moving ahead with major initiatives on energy market liberalization, external energy security, renewable energy, and climate change.

16. (U) In September 2007, the European Commission presented the "Third Energy Package" intended to increase competition and investment in the internal market for gas and electricity. In January 2008, as part of its Climate and Energy Package, the Commission submitted proposals to increase the share of renewables in the energy mix, promote energy efficiency, and create cleaner-burning fossil fuels. The Commission has also been promoting a number of gas pipeline projects to help meet expected increases in European gas demand.

Internal Energy Markets

¶17. (U) New energy sector liberalization proposals under consideration in the EU could have an important role in facilitating distribution of gas from the east, whether from Russia or the Caspian region. The Commission's legislative package of two draft directives and three draft regulations proposed in September 2007 are designed to ensure greater competition and third party access by effectively separating supply/production of electricity and gas from transmission networks.

¶18. (U) Under the proposals, vertically integrated suppliers would have to either sell off their transmission networks or arrange for their transmission operations to be done by an "independent" subsidiary. Just how independent this subsidiary would actually be is currently being debated. To ensure that this effective "unbundling" does not result in transmission firms being bought up by foreign interests, the so-called "Gazprom Clause" would prohibit foreign (non-EU) companies from controlling gas pipelines and high voltage lines in the EU, although this prohibition could be waived if the home country of the firm has a bilateral or multilateral agreement with the EU. While we agree with the geostrategic considerations behind the Commission proposal, we are concerned that the provision as drafted could unintentionally affect potential U.S. investment in these transmission networks.

¶19. (SBU) Two key aims of the internal market reforms are to increase competition, and to encourage the building of interconnections among member states' electricity and gas grids. The potential gas grid interconnections could play an important role in enhancing European energy flexibility and security. For many of the countries of Central Europe the gas pipelines run one way (east to west) and many of these countries are heavily dependent on Russian gas supplies for their energy needs. Currently, if these Russian gas supplies are disrupted, there are no alternative supplies available. Building interconnections among these member states, however, would allow for gas to be rerouted from one member state to another in such an emergency.

¶10. (U) The Commission's proposals initially called for

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"full ownership unbundling" in the energy sector. However, a blocking minority of six countries in the Council (led by France and Germany) opposed forcing large energy producers to give up ownership of their distribution networks and proposed the so-called Third Option, which allows the continued existence of vertically integrated energy companies, but at the same time lays down strict conditions to ensure that transmission system operators do not discriminate against new market entrants.

¶11. (U) On June 6, Energy Ministers reached a political agreement on the Third Option, which is now also being backed by the Commission. In its first reading the European Parliament backed away from full ownership unbundling for gas, but supported full ownership unbundling for electricity.

The French Presidency of the EU is determined to reach a political decision on the Third Energy Package by the end of this year. If political agreement is reached by the end of the year, it could enter into force early next year. The provisions would then go to the Member States where they would have to be transposed into national law before they actually take effect. However, if political agreement is not reached by the end of the year, the process likely will be postponed until after the Parliamentary elections next summer and perhaps much longer.

External Energy Policy

¶12. (U) About one-quarter of total European energy

consumption is based on natural gas. Recent International Energy Agency (IEA) predictions suggest that gas demand in the EU will more than double by 2030, while Europe's own production -- now primarily from the North Sea and Norway -- is declining. Meeting the new demand will require significant increases in gas-imports and import capacity. The IEA estimates that annual European demand could increase by about 200 billion cubic meters (bcm), or 7 trillion cubic feet, over the next two decades from 500 bcm now, while production declines from roughly 300 bcm to about 200 bcm. Today Russia itself accounts for about a quarter of the EU 27's import needs, while imports from Norway, Algeria, and the Caspian and Central Asian states through Russia comprise the remainder. The dependence on Russian gas is much higher for many Central European countries who rely on Russia for more than 75 percent of their gas imports. The EU will have to develop a number of new transport pipelines if it is to reduce this over-dependency on gas coming from and through Russia.

¶13. (U) The Commission and Council have proposed a more robust role for the European Union in developing an external energy policy. Javier Solana, whom you will see, has publicly argued for more effective EU coordination on external energy issues, with the strong backing of the Central European states, who are most concerned about Gazprom's hegemony and continued German courting of Moscow. EU Energy Commissioner Piebalgs supports this as well. The Treaty of Lisbon, rejected in the recent Irish Referendum, contains language intended to give the EU additional say over crafting and implementing a common external energy policy. That said, many member states remain divided on what the policy should be, and the EU does not speak with one voice on external energy issues. Russia has excelled at exploiting the divisions among member states with Gazprom continuing to make inroads into European gas distribution and supply.

¶14. (SBU) To date, the Commission has publicly taken an open approach to new gas infrastructure projects. While supporting the Nabucco and Turkey-Greece-Italy Interconnector (TGI) pipeline projects they have also supported the Russian Nord Stream and South Stream projects, even though South Stream, which could transport about 30 bcm of gas a year from Russia and Central Asia via a Black Sea route that bypasses Turkey, is a direct competitor to the Nabucco project. Privately, Commission officials have indicated they prefer the non-Russian solutions, but view South Stream as a convenient bargaining tool in transit negotiations with Turkey.

¶15. (SBU) In the fall of 2007 the Commission appointed Jozias Van Aartsen, former Dutch Foreign Minister and current Mayor of the Hague, as a special Coordinator for the Nabucco project. Van Aartsen's original mandate was to facilitate the negotiation of the transit agreement and necessary

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inter-governmental agreements to enable the Nabucco project. Van Aartsen's mandate has since been redefined to include all the Southern Corridor projects intended to bring Caspian region gas to Europe. Van Aartsen's focus so far has been on working with Turkey to arrive at terms for a transit agreement that would be attractive to European buyers and Caspian producers, while still meeting Turkey's concerns over its own security of gas supply concerns. The major sticking point from the EU side has been Turkey's insistence on a 15 percent take off clause allowing Turkey to take 15 percent of any gas flows at a reduced rate.

¶16. (SBU) The U.S. has been supportive of the EU's efforts to open up the Southern Corridor. Special Envoy C. Boyden Gray and Deputy Assistant Secretary Matt Bryza in particular have held numerous discussions with the Europeans, Turkey, and representatives from producer and consumer states with the aim of encouraging them to find a middle ground that will allow the gas to flow. From the U.S. standpoint, opening

the Southern Corridor is a win, win, win scenario, in providing greater independence for the Caspian States, increasing Turkey's ties with the West, and increasing Europe's energy security.

Energy and Climate Change

¶17. (U) While its external powers are still relatively limited, the Commission has power under environmental and internal market rules to promote broad measures on climate, energy security, and competitiveness. Commissioner Piebalgs and others will likely raise these issues with you because the Commission sees energy security as an integral part of a broad package of measures including renewables, clean coal, nuclear power, and emissions trading, in addition to new sources of gas supply.

¶18. (U) On January 23, the European Commission announced a new energy and climate change legislative package to implement the March 2007 mandate from EU leaders to achieve reductions of 20 percent in EU carbon emissions by 2020. Although this legislation is not quite as far along as the energy liberalization package, again the French intend to push this to at least political agreement by the end of their presidency.

¶19. (U) One of the most hotly contested parts of this package is the allocation of the greenhouse gas (GHG) reduction among the member states. Poland recently broke ranks over emissions caps proposed in the new legislation, arguing that reducing dependence on coal -- currently 96% of Poland's electricity generation -- in favor of renewables would present a large obstacle to economic growth. Poland's other option, replacing coal with natural gas, would require a new dependence on Russia, which Poland claims will sacrifice energy security. Poland claims to have up to eight member states supporting it, although these have not yet been identified. In addition, many of Europe's traditional energy-intensive industries -- including steel, autos, chemicals and cement -- are deeply concerned that the EU's ambitious GHG reduction targets could seriously disadvantage them globally; they could at the very least try to ensure the EU retains the ability to "level the playing field" by imposing a carbon tax on imports.

¶20. (U) A third issue is the development and use of renewable energies. The Commission included proposals to increase renewable energy to 20 percent of the EU total and reach 10 percent alternative fuels use for transport, also by ¶2020. (The transport directive is often called the biofuels mandate, named for the fact that biofuels are expected to comprise the majority of the 10 percent, as opposed to hydrogen fuel cells or electric cars.) The biofuels mandate has come under the most scrutiny because of the fuel or food argument and also because of concerns raised over sustainability.

¶21. (SBU) The EU, like the United States, understands that measures that enhance energy technology to address climate change concerns are also directly related to energy security needs. That said, they often emphasize the climate connection in their rhetoric, and distinguish their own "environmental" aspirations from our "energy security" concerns. We have been trying to erase this false dichotomy by emphasizing that the U.S. and EU have shared concerns on

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both global warming and energy security, and that stepped-up transatlantic collaboration on energy technologies helps address both. It will be helpful if you can reinforce this theme in your public comments by pointing to the robust domestic energy program the President and Congress have instituted, as well as our robust and growing U.S.-EU cooperation on energy efficiency, biofuels, hydrogen fuel cells, solar power, and carbon capture and sequestration.

¶22. (SBU) It will also be extremely useful if you highlight the President's efforts to advance the UN Framework Convention on Climate Change (UNFCCC) negotiations through the Major Economies Process. Any international agreement that does not include binding commitments on China and other key emerging countries will likely draw a skeptical response in Washington. This is also a shared U.S.-EU interest; we need the EU to work more actively with us to attain a global solution.

¶23. (SBU) To sum up, you are coming to Brussels as key energy and climate related proposals are being debated widely. The European Commission and Solana are frustrated by the lack of a common EU energy policy, but with member states still jealously guarding their prerogatives it has been difficult for Brussels to play a greater role. Though its energy policy is nascent, Brussels nonetheless does have powers and is pressing for more.

Silverberg

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